

THE DEBATE OVER THE DEBT CEILING IN THE US, A CASE OF POLITICS GONE WILD?

The ongoing debate (or should we say war of words) amongst U.S. politicians over the need to increase the existing debt ceiling has taken center position on the global economic stage. Both sides of the political world in the US are competing daily to scare the public into adopting their view of the government's role in the economy and the President appears to enjoy taking the podium and arguing all sides are acting in misguided fashion. The true issue of course is the impact of all this mudslinging and political rhetoric on investors, the economy and markets. In this edition of the Marker we review some of the background on the matter and highlight the likely steps to be taken by authorities in the near term.

A PRIMER ON THE DEBT CEILING

The debt ceiling was created by a law of the US Congress in 1917 to help finance the country's involvement in World War 1. The legislation was modified in 1939 on the eve of World War II for similar reasons. From 1962 onward Congress enacted some 69 separate measures - usually without much debate - to modify rules surrounding the national debt¹. The legislation has been used in the past to embarrass the ruling government into cutting expenses. The most extreme case occurred in 1995 when Republicans (under Newt Gingrich) forced a shutdown of the Clinton government over the issue. The current debate is thus really over a legal technicality. It has however been high jacked to a political end at a time of extreme polarization in Washington.

POLITICIANS PLAYING 'CHICKEN' WITH FINANCIAL MARKETS AS THEY POSITION FOR THE 2012 ELECTION SEASON

If one manages to observe the situation from a distance and resists falling prey to the hyperbole, one realizes that the intensity of the fight arises from the desire by both Republicans and Democrats to position the issue of government spending to their advantage for the 2012 election. Republicans (the right) wish to place the size and role of government in the lives of US citizens at the very center of the 2012 political debate. They choose government spending - the ceiling must be raised because of ongoing deficits - as the battle field. Democrats - including the President - wish to proceed with a modest increase now and delay the fundamental debate until after the election.

In choosing to place politics ahead of all other considerations Washington ends up further tarnishing its own image but more importantly creates significant uncertainty at a time when a much needed economic recovery is losing steam. Who in their right mind would want to compete with headlines on Greece for economic and political dysfunction? Confidence drives behaviour and investors are receiving daily reminders that the US may very well not be capable of governing itself as the AAA rated financial backbone of the global financial system it has become to be recognized as.

Politicians are all about being re-elected. They know deep down that a replay of the 1995 shutdown would not serve their interest - interestingly enough the Republicans suffered most from the episode. So we can expect normal operations from the US Government next week and no default on debt payments. The stature of the US may however suffer from this episode of political silliness for several months to come. As to markets, the weakness of the US dollar serves as proof of the very real costs of playing extreme politics.

NATCAN MARKER

The US debate surrounding the debt ceiling is truly the starting signal of the 2012 Presidential and congressional elections. While outright default will be avoided the increased political uncertainty in the world's leading economy will remain for several months. The bottom line for investors will be greater volatility. Enjoy the ride and stay diversified!

Michael Quigley, CFA, CAIA

FINANCIAL MARKETS

RETURNS AS AT JULY 26, 2011 (%)	MTD	QTD	YTD	RATES AS AT JULY 26, 2011	
S&P/TSX	0.11	0.11	0.27	CAD/USD	0.94
S&P 500	-1.31	-1.31	1.17	CAD/Euro	1.37
S&P/TSX Small Cap	3.02	3.02	-1.42	US Treasuries yield 10-yr/30-yr	2.95/ 4.28
Russell 2000	-2.51	-2.51	0.11	GOC bond yield 10-yr/30-yr	2.89/ 3.37
MSCI EAFE	-1.55	-1.55	0.38	Fed Fund Rate (target)	0.25
MSCI World	-1.35	-1.35	0.88		
DEX Universe Bond	1.46	1.46	3.69		

Note: Returns in Canadian dollars, London 4h exchange rates. Source: Datastream, PC Bond, MSCI-Barra, and Bloomberg. PC-Bond, a business unit of TSX Inc. Copyright © TSX Inc. All rights reserved.

This publication is intended for your personal use. The information and opinions herein are provided for informational purposes only and are subject to change based on market and other conditions. The views expressed should therefore not be relied upon as the basis of your investment decisions. Past performance is not necessarily indicative of future performance. This document is not and should not be construed as a solicitation or offering of units of any fund or other security in any jurisdiction. No part of this publication may be reproduced in any manner without the prior written permission of Natcan Investment Management Inc. All market index returns presented in this commentary are expressed in Canadian dollar terms and were provided by Thomson Reuters, Standard & Poor's, a division of McGraw-Hill Companies Inc. and PC-Bond, a business unit of TSX Inc, unless otherwise specified.

¹ BMO – July 27 2011